UK Risk Settlement Bulletin

Q2 2020

COVID-19 and the death of normality

The short-term impact of the COVID-19 outbreak on UK mortality is unprecedented in recent times. It appears that deaths from COVID-19 have peaked in the UK, but experience from other countries suggests that:

- The rate of decline will be lower than the initial rate of increase; and
- While social distancing and lockdown has been an effective strategy for inhibiting the spread of COVID-19, initially at least it does not stop the spread altogether.

Data from the Office for National Statistics also shows the impact the pandemic has had on the number of deaths arising for reasons other than COVID-19, something else to monitor closely.

The chart on the right tracks cumulative weekly reported deaths in England & Wales in the first part of 2020 (the dark line) compared to the average for the previous three years (the dotted line), splitting the deaths into 'Non-COVID-19' and 'COVID-19'.

The chart is currently based on data up to 17 April 2020. You can see that experience up to this date shows that cumulative deaths in 2020 are already outside the range of outcomes seen in the last seven years (the shaded zone).

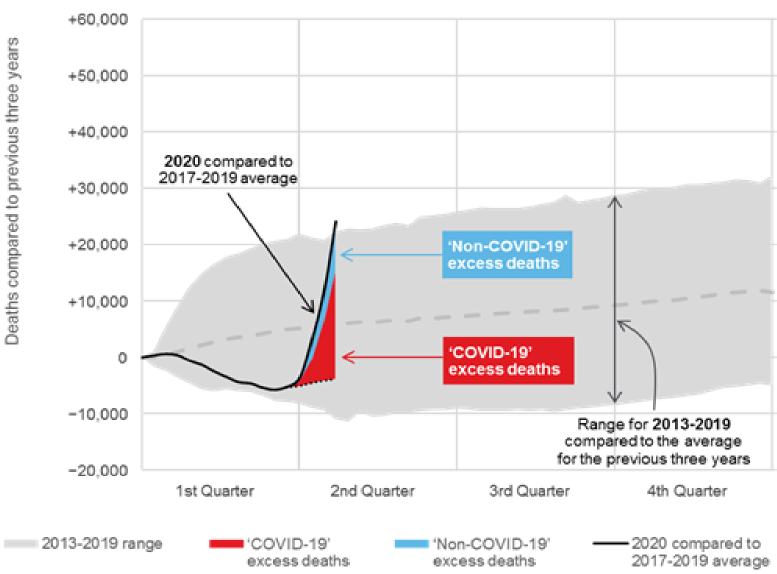
The impact on longevity for pension scheme members will additionally be affected by the indirect impact of COVID-19, including:

- The health of the surviving population; and
- The economic, social and political consequences of tackling the virus.

In both of the above cases, the impact on longevity could be positive or negative.

Given the high uncertainty surrounding the data available and projections of mortality, please seek advice from Aon's specialist Demographic Horizons team, via your usual Aon consultant, before making any decisions specifically related to the longevity impact of COVID-19.

Cumulative deaths in the calendar year
versus average for the previous three years



Source: Data from the Office for National Statistics, analysed by Aon's Demographic Horizons.

Insurer bulk annuity cost

The recent volatility in financial markets has generally improved bulk annuity pricing.

A key driver of changes to bulk annuity pricing is the yield available on assets used by insurers to back annuities (such as corporate bonds). These yields generally improved in March, as financial markets responded to the evolving COVID-19 situation.

During the same period of volatility, we saw a fall in the yields of low-risk assets, such as swaps and government bonds (gilts).

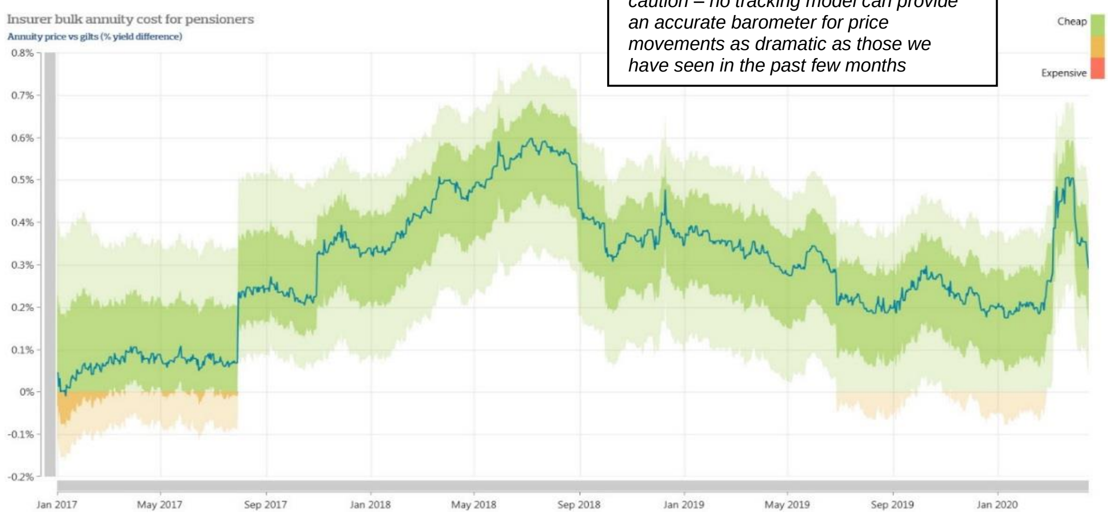
The combined impact was a significant improvement in bulk annuity pricing, relative to gilts, during March 2020. This can be seen on the chart below, which shows the expected range of pensioner pricing relative to gilt yields for a typical scheme.

Some schemes which had been considering a transaction were unable to capitalise on the pricing available during this period, pausing deals, for example being hampered by credit trading costs or increases in gilt collateral demands for LDI programmes (we have seen some of these constraints reduce in April as market liquidity improved).

Thus, while pricing has fallen away slightly at the start of April, the remainder of 2020 may be more of a buyers' market for schemes which are able to mobilise.

Clearly this may be difficult, but schemes well hedged with some low-risk investments, as well as strong governance in place to act quickly, might be able to access the pricing opportunities.

This illustration should be treated with caution – no tracking model can provide an accurate barometer for price movements as dramatic as those we have seen in the past few months



How to read this chart

- This shows the return from a bulk annuity for pensioners, relative to the yield on a comparable gilt portfolio, assuming insurer-type assumptions beyond the discount rate.
- A higher position represents a better price.
- This comparison ignores the material value from annuities giving a better hedge than gilts, including longevity cover.
- Expected pricing for a typical scheme is shown by the blue line.
- Prices typically fall in the darker shading, and some auctions fall in the lighter shading. Pricing outside the shading typically represents an unusual liability profile.

Chart sourced from Aon's Risk Analyzer

Volatile markets – funding level resilience

The significant market volatility in recent months has significantly affected interest rates, inflation, growth assets, and credit spreads. This has impacted bulk annuity pricing and scheme asset portfolios. How has this changed the level of UK pension scheme funding?

Funding levels

Aon's Risk Analyser uses our Bulk Annuity Market Monitor to track the buy-out funding position of around 200 UK pension schemes, covering over £200bn of assets. Our analysis of schemes over the period 31 December 2019 to 31 March 2020, summarised in the chart below, reveals that:

- Buy-out funding levels have held up more strongly than might be expected given the large falls in equity markets. The average buy-out funding level has fallen by only around 3% (shown by the dashed grey line).
- Buy-out funding levels have fallen by approximately half the amount of technical provisions funding levels (assets falls have been offset by better annuity pricing).
- Around a fifth of schemes have benefited from an *improvement* in their buy-out position. These schemes (shown in the green shaded area on the chart) tend to have low equity allocations and high levels of hedging.

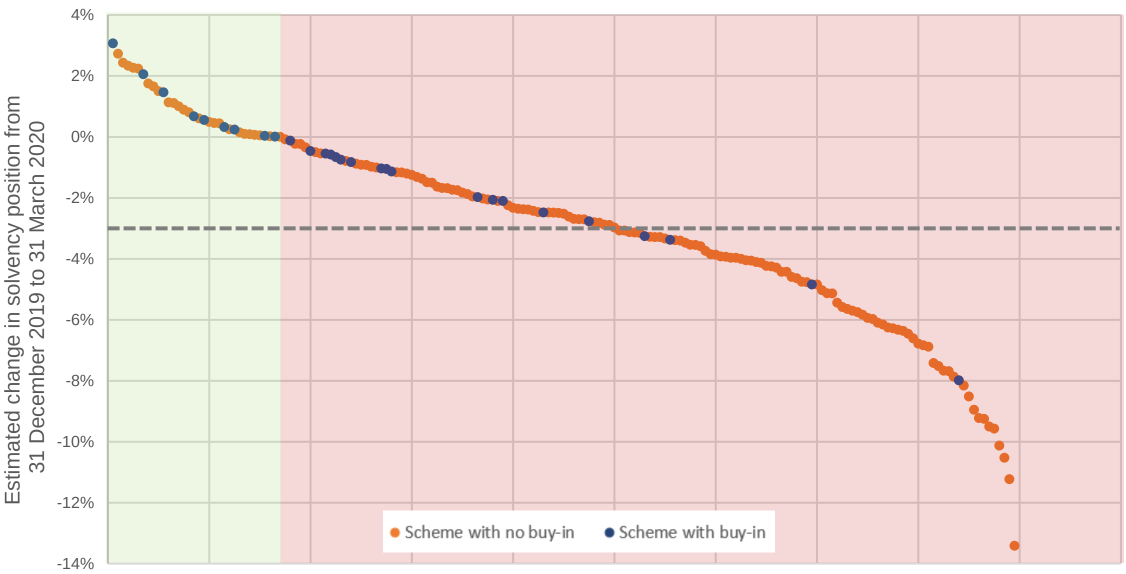
Settlement protection

Schemes which previously purchased a buy-in (the darker dots on the chart) have generally seen their funding levels protected more than those without insurance (the lighter dots).

Indeed, those schemes *without* a buy-in have suffered an average fall in funding level three times greater than those *with* annuities.

Please get in touch with your usual Aon contact if you would like to discuss how your Scheme's buy-out position has changed recently.

Change in solvency position for schemes on Risk Analyzer



Source: UK pension scheme data via Aon's Risk Analyzer.

Bulk annuities – going global

The UK bulk annuity market hit a record volume of £43Bn in 2019. Similarly, global settlement markets continued to grow rapidly and deliver good opportunities to insure pension plan liabilities in other territories. This article focuses on three of the largest markets: the US, Canada, and the Netherlands.

US continues growing

2019 saw $30Bn of premium across 506 transactions (an average deal size of $60M). This was the largest settlement year for the US since 2012, when a huge $26bn buy-out for General Motors dominated the market. Recent market activity is shown on the chart below.

Similar to the UK, US total industry volume is often driven by a few very large transactions (e.g. Lockheed Martin's $1.9Bn transaction in December 2019), but there were many smaller / mid-sized deals keeping the market active.

Despite the continued low-interest rate environment, US pricing remained very competitive for plan sponsors relative to their corporate balance sheet liabilities. 2019 saw a change in focus, with an increase in full plan terminations where previously the market was dominated by pensioner deals.

Canada

Last year was a strong year for the Canadian market, which grew by over 10% to C$5.2Bn. Pensioner pricing typically achieves a spread above the yield available on sovereign bonds so, as in UK, this gives an opportunity for Plans to increase their investment returns by trading sovereign debt for annuities, removing risk at the same time. The pricing available continues to vary significantly between deals by duration, given longer-dated Canadian sovereign bonds represent a relatively illiquid market.

Over half of the deals in 2019 were buy-ins, with better pricing seen for 'blue collar' transactions.

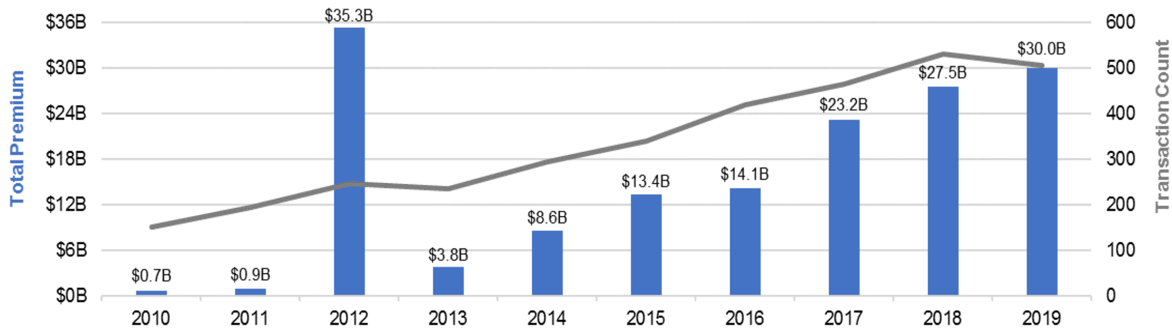
Netherlands

In the Netherlands there has been a trend away from insurance towards plan consolidation. Pension funds transfer their assets and liabilities to larger funds, often industry-wide pension funds (similar to the concept of commercial consolidators / DB Master trusts in the UK).

The rest of the world

In other territories we see settlement markets at varying stages of maturity. For sponsors looking to de-risk their global liabilities in less established markets, there are now a number of global insurers who can provide insurance solutions across multiple jurisdictions.

The US settlement market in numbers



Source: As reported in insurer responses to Aon US's quarterly survey, includes both pensioner buy-outs and full plan terminations.

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Compliance code: A112-301020